

Internal Revenue Service

memorandum

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to: District Counsel, Sacramento CC:SAC
Attention: Revenue Agent Bob C. Paget
Redding POD

from: Director, Tax Litigation Division CC:TL

subject: Home Rental Videotapes
[REDACTED]

This is in response to your request for technical advice dated August 16, 1988, on whether taxpayers are entitled to use the income forecast method of depreciation for home rental videocassettes under I.R.C. § 167.

ISSUE

Whether taxpayers are entitled to use the income forecast method of depreciation for home rental videocassettes under section 167. 0167-0500; 0167-0301

CONCLUSION

Rental videocassettes placed in service after March 28, 1985, must be depreciated under section 167 in accordance with the income forecast method or, alternatively, in accordance with the straight line method over the useful life of the videocassettes in the particular taxpayer's business. If the property was placed in service prior to March 28, 1985, and the useful life is three years or more, then the taxpayer may use one of the accelerated methods of depreciation under section 167(b).

FACTS

The taxpayers are engaged in videotape rental activities. They purchase videotapes of current (new release) and older movies which are then rented to the general public. The taxpayers did not participate in the production of the movies either as investors or through pre-production licensing agreements. The taxpayers have claimed depreciation equal to ninety percent of the cost of the videotapes acquired each year. Under copyright law it is illegal for the taxpayer to make copies of the videocassettes.

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DISCUSSION

Generally, section 168(a) applies to all tangible property placed in service after December 31, 1980, except as otherwise provided in section 168. Section 168(f)(3), (previously section 168(e)(5)) provides that section 168 does not apply to any film or videotape. See attached copy of technical advice of December 19, 1987. If property is excluded from section 168, the provisions of section 167 apply in determining the allowable depreciation deduction.

Section 167(a) provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion and wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business or held for the production of income.

Section 167(b) provides that the term "reasonable allowance" shall include an allowance computed under the straight line method and certain accelerated methods. Section 167(c) provides that the accelerated methods of depreciation described in section 167(b) apply only to tangible property with a useful life of three years or more. The section also provides that accelerated methods do not apply to any motion picture film, video tape or sound recording. This latter provision was added by the Tax Reform Act of 1986, effective for property placed in service after March 28, 1985. The legislative history states, however, that the income forecast method of depreciation is available with respect to motion picture films, videotapes and sound recordings. H. Rep. No. 99-841, 99th Cong., 2d Sess. 914-915 (1986).

The taxpayer's allowable depreciation deduction must be determined under section 167 if the rental videocassettes are excluded from section 168. Section 167(b) provides for straight line depreciation over the life of the property and for certain accelerated methods. These accelerated methods of depreciation, however, apply only to tangible personal property with a useful life of three years or more in the taxpayer's business. While the useful life is a facts and circumstances determination, it is unlikely that the videocassettes have a useful life of three years or more.

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For property placed in service after March 28, 1985, section 167(c) specifically prohibits any motion picture film or videotape from being depreciated in accordance with the accelerated methods. There is nothing in the legislative history to indicate that this broadly inclusive language does not encompass rental videocassettes. This same history, however, does provide that the income forecast method may be used for motion picture films and videotapes.

Accordingly, assuming that the useful life of the videocassettes is not more than three years or the property was placed in service after March 28, 1985, the taxpayer must depreciate the videocassettes utilizing the income forecast method of depreciation or the straight line method over the useful life of the videotapes in the taxpayer's business.

The income forecast method of depreciation is described in Rev. Rul. 60-358, 1960-2 C.B. 68. This method recognizes that certain assets generate uneven flows of income and have unique income producing potential. For example, like the underlying movies, some videocassettes will be more popular than others and will generate more income over a longer period of time than less popular ones. Because of these characteristics, in order to properly apply the income forecast method, estimated income projections must be made by a taxpayer for each particular asset subject to the method. A taxpayer utilizing the income forecast method in its videocassette rental business should make income projections with respect to each movie title in its inventory of rental videocassettes.

The taxpayer may also depreciate the videotapes using the straight line method over the useful life of the asset in the business. The useful life of rental videocassettes may vary as a result of the different business circumstances of particular taxpayers in the videocassette rental business. For example, the videocassettes of a store with a high volume business may be subjected to a greater amount of physical wear and tear than those of a store with a lower level of business. The videocassettes of the high volume store may, therefore, have a shorter useful life for depreciation purposes. In general, the Service will accept without question a useful life of two years. In the facts submitted with the request for technical advice, it is the taxpayers' burden to prove that ninety percent of its videotapes have a useful life of one year or less.

In the event that the taxpayer demonstrates that the useful life of the videocassettes in its business is more than three years and the property was placed in service before March 28, 1985, then the taxpayer would be eligible to use one of the accelerated methods of depreciation described in paragraphs (2), (3) and (4) of section 167(b) if the videotapes are tangible personal property. Section 167(c). We conclude that the rental videocassettes are tangible personal property for purposes of section 167(b) for several reasons.

First, neither the Code nor the regulations provide clear guidance for the resolution of whether videocassettes are tangible personal property. Treas. Reg. § 1.48-1(c) categorizes tangible personal property as any tangible property, except land and improvements thereto, such as buildings and other inherently permanent structures. Treas. Reg. § 1.44-1(f) provides that intangible property is property such as patents, copyrights and subscription lists.

Legislative history on the subject is neutral. In its explanation of the 1986 change in section 167(b) regarding films, videotapes and sound recordings, the Joint Committee stated that if these properties do not qualify as recovery properties under section 168 but do qualify as tangible personal properties, the taxpayer may recover their cost under one of the accelerated methods of section 167(b). Joint Committee on Taxation, Explanation of Technical Corrections of the Tax Reform Act of 1986, Pub. L. 99-514, 100th Cong., 1st Sess., 48-49 (1987). With this statement, however, the committee was not determining that these items were tangible personal properties; the report states that no inference is intended concerning whether films, videotapes or sound recordings qualify for the accelerated methods. *Id.* at 49.

Next, we do not believe the Service could prevail litigating a position that the videotapes are intangible property. In general, the position of the Service has been that property is intangible if its intrinsic value is attributable to an intangible element, such as a copyright, rather than to any of its specific tangible embodiments. The court rejected this argument in the context of films, where the court analogized the master negatives for each film title to a machine which stamps out copies. As the machine is a tangible capital asset, so is the film. Walt Disney Productions v. United States, 549 F.2d 576, 581 (9th Cir. 1976). Even where the court applied the intrinsic value argument, it found that magnetic tape containing geological survey information was tangible property.

"[T]he value of the seismic data was totally dependent upon the existence of the tapes and films." Texas Instruments, Inc. v. United States, 551 F.2d 599 (5th Cir. 1977), aff'g in part and rev'g in part 407 F.Supp. 1326 (N.D. Tex. 1976).

The government has had success in the area of computer software. The courts have held that the intrinsic value of the software is attributable to an intangible element (the computer program) that is not inextricably connected to the tangible medium because the program could be downloaded electronically over transmission lines or typed in by a human programmer. Ronnen v. Commissioner, 90 T.C. No. 7 (January 21, 1988); Bank of Vermont v. United States, 88-1 U.S.T.C. par. 9169 (D. Vt. 1988).

Based on the distinction made by the court between magnetic tapes and computer software, we believe that rental videocassettes are more analogous to the magnetic tapes, and therefore, we could not rely on the computer software cases as authority that videocassettes are intangible property. In particular, the intrinsic value of the cassettes is not attributable to any intangible element. As the taxpayer has no copyright interest in the videocassettes nor any exclusive right of exploitation and is prohibited by law from reproducing the videocassettes, their value depends entirely upon the existence of the tangible medium of the film. When the videocassettes wear out or are destroyed, they are of no further commercial value to the taxpayer. Thus, the useful life of this property to the taxpayer is a function of wear and tear and as such the videocassettes are in a real sense depreciable tangible property.

In summary, rental videocassettes placed in service after March 28, 1985, are not depreciable under section 168 but may be depreciated by means of the income forecast method on a title by title basis or on a straight line basis over the life of the property. The life of the property is a facts and circumstances determination, but the Service will not question a two year life. If the property was placed in

service before March 28, 1985, and the taxpayer is able to prove that the useful life is more than three years, then the taxpayer may recover the cost of the videocassettes under one of the methods of accelerated depreciation under section 167(b).

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